

**Earned Income Credit Was Paid to Taxpayers
Who Did Not Provide Required
Documentation During Audits**

October 2001

Reference Number: 2002-40-004

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



INSPECTOR GENERAL
for TAX
ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

October 10, 2001

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Earned Income Credit Was Paid to Taxpayers
Who Did Not Provide Required Documentation During Audits
(Audit #200140034)

This report presents the results of our audit to determine if the Internal Revenue Service (IRS) ensured that taxpayers provided required documentation to justify Earned Income Credit (EIC) claims during audits.

In summary, we found that taxpayers did not receive consistent treatment when the IRS audited their EIC claims. Specifically, some taxpayers were allowed the EIC without having to provide required documentation to justify the EIC claim during the audit.

IRS management agreed with our recommendations and will initiate corrective actions. Management's comments have been incorporated into the report, where appropriate, and the full text of their comments is included as an appendix.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Stanley C. Rinehart, Acting Assistant Inspector General for Audit (Wage and Investment Income Programs), at (972) 308-1670.

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Not Provide Required Documentation During Audits**

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Earned Income Credit Was Paid to Taxpayers Who Did Not Provide Required Documentation During Audits

Background

The Earned Income Credit (EIC) is a refundable tax credit created in 1975 to offset the impact of Social Security taxes on low-income families and encourage them to seek employment rather than welfare. The Congress assigned responsibility to the Internal Revenue Service (IRS) to administer the EIC. The IRS defined this role as ensuring effective administration of the law; achieving full participation¹ of eligible taxpayers; and reducing overclaims² and fraud, waste, and abuse. In Calendar Year (CY) 2000, a total of 19,226,015 taxpayers received the EIC.

The IRS selects a taxpayer's return with an EIC claim for audit when there are questions on whether the taxpayer is entitled to the claim. During an EIC audit, a taxpayer is required to provide the IRS with documentary evidence to prove his or her entitlement to the EIC claim. In 1999, the General Accounting Office had reported³ that taxpayer documentation required to justify the claims for EIC varied among IRS Tax Processing Centers. As a result, the IRS took steps to improve its efforts to verify whether taxpayers were entitled to their EIC claims. Specifically, it revised forms available to taxpayers to include a list of items considered appropriate for supporting an EIC claim. The IRS also provided uniform guidance to its tax examiners for conducting audits with EIC issues.

While most EIC claims are not questioned by the IRS, it did complete 325,654 audits and recommended over \$411 million in additional taxes where EIC claims were in question in Fiscal Year (FY) 2000. Audits of EIC claims represented 74 percent of the total audits completed by the IRS' Remote Examination function during the fiscal year.

¹ Full participation is defined as having all taxpayers that are entitled to the EIC claim it.

² EIC overclaims involve both intentional and unintentional (mistakes) attempts to file returns with EIC claims that fail to meet eligibility requirements.

³ *Weaknesses in Selecting and Conducting Correspondence Audits*, (AD-99-48).

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Earned Income Credit Was Allowed to Taxpayers Who Did Not Provide Required Documentation To Justify These Claims

This audit was conducted at the Remote Examination National Headquarters and the Andover, Fresno, and Kansas City Tax Processing Centers from April to June 2001. This audit was performed in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to this report are shown in Appendix II.

Taxpayers are not always treated consistently during audits of their EIC claims. Our review of 280 taxpayer audits with EIC issues from 3 Wage and Investment (W&I) Tax Processing Centers⁴ found that 26 (9 percent) taxpayers were allowed \$72,126 in EIC without having to provide all required documentation to justify these claims. For example, in 1 case, a taxpayer was allowed \$3,816 in EIC even though he or she did not provide documentation to verify that the children being claimed for the EIC lived with the taxpayer as required. Instead, the tax examiner accepted a verbal statement from the taxpayer that the children did in fact reside with the taxpayer. See Appendix V for additional case examples.

The Internal Revenue Code (IRC)⁵ requires taxpayers to meet specific tests to show that a qualifying child being claimed for the EIC is of a certain age, is related to the taxpayer, and lived with the taxpayer during the tax year. Taxpayers are required to provide documentary evidence during an EIC audit proving that the tests required by the IRC have been met, including:

- ◆ A birth certificate of the child being claimed for the EIC to verify the age and relationship to the taxpayer.
- ◆ A Social Security card for the taxpayer, spouse, and qualifying children to ensure Social Security numbers are valid for work in the United States.
- ◆ Documentation of the qualifying child's residency, such as school records, medical records, or childcare

⁴ These 3 W&I Tax Processing Centers closed 12,625 cases during the sampling period.

⁵ Internal Revenue Code, 26 U.S.C. § 32(c)(3).

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provider statements to confirm the child lived with the taxpayer.

- ◆ A listing of individuals who lived in the same home as the taxpayer to ensure that there is not someone else in the household who can claim the qualifying child/children and has a higher Adjusted Gross Income. If so, the original taxpayer cannot get the EIC.

IRS procedures require front-line managers to review audits (case reviews) to ensure consistency and accuracy. A case review is a review of an in-process or closed audit worked by a specific employee. Among other things, these case reviews assess whether the tax examiner obtained required documentation during the audit to support the allowance/disallowance of the EIC claim.

Contributing Factors

Managerial case reviews were not performed adequately. Our review of 55 tax examiner Employee Personnel Files (EPF) found that:⁶

- ◆ Six employees (11 percent) had no case reviews performed on their work during a 1-year period (April 2000 to April 2001).
- ◆ Eleven employees (20 percent) have not had a case review during CY 2001 (January to April 2001).
- ◆ Eight (15 percent) employees were not adequately reviewed according to local procedures.⁷
- ◆ Thirty (55 percent) employees were reviewed consistent with local procedures.

Guidelines did not specify the numbers or frequency for the performance of managerial case reviews. Discussions with the

⁶ Percentages below add to 101 percent due to rounding.

⁷ Fresno and Kansas City had local procedures for managerial case reviews. Fresno required at least one review per quarter and Kansas City procedures required three reviews per month or eight reviews per quarter.

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three Tax Processing Centers we visited showed that only two of the three Centers had local procedures that required, at a minimum, one case review per employee per quarter.

For FY 2000, the IRS completed 325,654 audits of taxpayers where there were issues related to the EIC. For FY 2001, the IRS plans to complete 422,210 audits of taxpayers where there are concerns with the EIC. Without an effective process to obtain required documentation to support EIC claims, all taxpayers may not be consistently treated. Therefore, taxpayers could be allowed the EIC even when they have not provided the required documentation to justify the EIC claim.

Recommendation

The Commissioner, W&I Division, needs to:

1. Develop expectations that case reviews be completed, and establish a process to ensure these reviews are done timely.

Management's Response: The Director, Exam Strategy and Selection Unit, will issue guidance on managerial case reviews. Adherence to this guidance will be verified through periodic reviews of employee personnel files during site operational reviews.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine if the Internal Revenue Service (IRS) ensured that taxpayers provided required documentation to justify Earned Income Credit (EIC) claims during audits.

To accomplish our objective, we determined if the IRS had clear criteria and guidance for its employees to follow to ensure taxpayers provide required documentation to justify their EIC claims during correspondence audits.

- I. To determine the minimum documentary evidence required to be provided by taxpayers to justify EIC claims during a correspondence audit, we interviewed National Headquarters Remote Examination function management and local Examination function management, Unit Managers, and Lead Tax Examiners in the three Tax Processing Centers we visited (Andover, Fresno, and Kansas City).
- II. To determine if the IRS employees consistently followed required criteria and guidelines when deciding if documentary evidence required to justify taxpayer EIC claims were sufficient, we reviewed a random sample of 280¹ Remote Examination function cases closed between October and December 2000. Sampling was done by choosing the n th case, where n equals the number of closed cases divided by 100. These were Wage and Investment taxpayer cases that were audited for EIC issues and had a reply from the taxpayer. Cases were chosen and reviewed from the Andover, Fresno, and Kansas City Tax Processing Centers due to their high volume of closed cases. These 3 Tax Processing Centers closed a total of 12,625 cases during our sampling period.
- III. To determine if EIC audit workpapers were managerially reviewed in an attempt to ensure consistency of taxpayer-provided documentation to support an EIC claim, we reviewed documentation of managerial case reviews for a random sample of 55 of the approximately 400 tax examiners from the 3 Tax Processing Centers we visited.

¹ We reviewed 100 cases from both the Andover and Kansas City Tax Processing Centers and only 80 cases from the Fresno Tax Processing Center since we did not receive all the requested cases in a timely manner.

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Appendix II

Major Contributors to This Report

Walter E. Arrison, Assistant Inspector General for Audit (Wage and Investment Income Programs)

Michael Phillips, Director

Russell Martin, Audit Manager

Edith Lemire, Senior Auditor

Mary Keyes, Auditor

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Appendix III

Report Distribution List

Commissioner N:C
Director, Compliance W:CP
Director, Compliance Services W:CP:CS
Director, Exam Strategy and Selection Unit W:CP:ESSU
Director, Strategy and Finance W:S
Chief Counsel CC
National Taxpayer Advocate TA
Director, Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis N:ADC:R:O
Office of Management Controls N:CFO:F:M
Audit Liaison:
 Director, Compliance W:CP

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Protection of revenue - Potential; \$72,126 (see page 2).

Methodology Used to Measure the Reported Benefit:

We reviewed a judgmental, random sample of 280¹ Remote Examination function cases closed between October and December 2000. Sampling was done by choosing the n th case, where n equals the number of closed cases divided by 100. These were Wage and Investment taxpayer cases that were audited for EIC issues and had a reply from the taxpayer. Cases were chosen and reviewed from the Andover, Fresno, and Kansas City Tax Processing Centers due to their high volume of closed cases. Our sample review found 26 (9 percent) of the 280 cases did not have all of the required documentation to justify an EIC claim. EIC totaling \$72,126 was granted to the 26 cases that had insufficient documentation.

¹ We reviewed 100 cases from both the Andover and Kansas City Tax Processing Centers. We reviewed only 80 cases from the Fresno Tax Processing Center since we did not receive all the requested cases in a timely manner.

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Appendix V

Case Examples

Example Number	Earned Income Credit Allowed	Missing Information
#1	\$3,816	Documentation to support residency.
#2	\$1,709	Social Security card for taxpayer and dependent and a birth certificate for dependent.
#3	\$2,655	Social Security card for taxpayer born in Mexico and a listing of individuals who lived in the home.
#4	\$3,139	A listing of individuals who lived in the home and documentation to support residency.
#5	\$3,423	Birth certificates for dependents claimed and the Social Security card for the taxpayer.
#6	\$1,947	Social Security card for taxpayer, documentation to support residency, and a listing of individuals who lived in the home.

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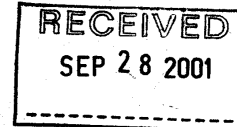
Appendix VI

Management's Response to the Draft Report



**DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308**

September 28, 2001



**MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION**

FROM:

John M. Dalrymple
Commissioner, Wage and Investment Division

SUBJECT:

Draft Report – Earned Income Credit Was Paid to Taxpayers
Who Did Not Provide Required Documentation During Audits
(Audit #200140034)

In Fiscal Year 2000, the IRS completed over 325,000 audits and recommended over \$411 million in additional taxes where the Earned Income Credit (EIC) claim was questioned. Your report titled "Earned Income Credit Was Paid to Taxpayers Who Did Not Provide Required Documentation During Audits" recognizes our progress in reducing EIC overclaims. We agree with your outcome measure for potential revenue protection.

The uniform guidance we give tax examiners for conducting EIC audits is the subject of ongoing improvement initiatives. In addition to improving adherence to auditing standards, we are working to improve consistent application of auditing techniques by developing job aids, and refining the quality assurance process. Further, we are strengthening our oversight and review process throughout the Examination function next fiscal year. We will incorporate your feedback on managerial reviews in the Examination Operating Guidelines.

Our comments on the specific recommendation in your report are as follows:

IDENTITY OF RECOMMENDATION 1

Develop expectations that case reviews are completed and establish a process to ensure these reviews are done timely.

ASSESSMENT OF CAUSE

We allowed taxpayers to claim the EIC without documentation. Our guidelines do not specify the frequency of managerial case reviews. Therefore, we did not treat taxpayers in a consistent manner.

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2

CORRECTIVE ACTION

The Director, Exam Strategy and Selection Unit, will issue guidance on managerial case reviews. We will verify adherence to this guidance through periodic reviews of employee personnel files during site operational reviews.

IMPLEMENTATION DATE

July 31, 2002

RESPONSIBLE OFFICIAL

Director, Exam Strategy and Selection Unit

CORRECTIVE ACTION MONITORING PLAN

Verify the timely completion of managerial case reviews during site operational reviews.

If you have any questions about this response, please contact William Zachery, Director, Exam Strategy and Selection Unit, at (404) 338-7643, or Karen Montpetit, Chief, Remote Exam, at (631) 654-6532.